Fraud Affects on Auditing: Some Critical Scenario

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Abstract

The key factor in enhanced credibility is the perception of external stakeholders that the external auditors judge to financial statements providing through the management. In recent years corporate scandals were happened, so investors demanding that auditors should be as an honest judge. Investors expect the auditors to detect fraud. The auditors although they view their role as bringing credibility to financial statements, know that because of scope and limitation of their responsibility cannot detect all kinds of fraud. However, may this question arise that why auditors take the position that they are not responsible for fraud detection: therefore it created expectation gap. In this paper the authors believe that at first legislators should be expand auditor responsibility for fraud detection, second auditors should do the best job, regarding fraud detection, therefore it will be reduce audit gap.

Key words: *Auditor, Responsibility, Fraud Detection, and Audit Gap*

1. Introduction

During the last years, there has been a great number of accounting scandals throughout the world; most recent that have been revealed are, among others; Enron, WorldCom parlmalat, and Famie Mac. These scandals have seriously damaged the confidence in financial reports, namely because of fraud. After these huge number of scandals had profound impact on the profession, leading to the disbanding of the Public Oversight Board (Mulligan, 2002) and the collapse of Arthur Andersen, one of the world'' largest accounting firms (Bayer). New legislation (e.g. Sarbanes -–Oxley Act of 2002) and a new oversight board are just a few of the effects resulting these scandals.

Fraud involves misallocation of resources or distorted reporting of the availability of resources, so this contradicts the elements of round and prudent management. In addition, these failures have focused attention on auditors' ability and incentives to detect management fraud. Audit failures arising from management fraud are largely responsible for efforts by regulators, legislators and accountants themselves, to require the accounting profession to accept more responsibility for evaluating and reporting on clients' and internal controls. Although the third party emphasize that auditor must be detect of kinds of fraud, the auditors thinking other ways; they believe that is not auditors duty the detect fraud; so, there is a gap, between auditors and third parties.

The fraud dimensions

Most of the research concerning fraud focused on so-called red flags which are defined as conditions that indicate potential fraud by management or others, with deliberate skills; Furthermore, several frauds reported in the last few decades have led to impair audit practice and audit financial statements.

Fraud, as it is currently defined in accounting standards, reports "an intentional act that results in a material misstatement in financial statements that are the subject of an audit (AICPA, 2003). There are two ways in which a material misstatement could occur with respect to fraud: a misappropriation of assets and fraudulent financial reporting. A misappropriation of assets, as the name suggests, refers to the theft of company assets that may result in the company's financial statements being materiality misstated (AICPA, 2003). According to IFAC (1977) fraud may involve:

- Misappropriation of assets;
- Suppression or omission of the effect of transactions from records or documents;
- Recording of transactions without substance, and
- Misapplication of accounting policy.

According to prosser (1971) the elements of fraud as follows:

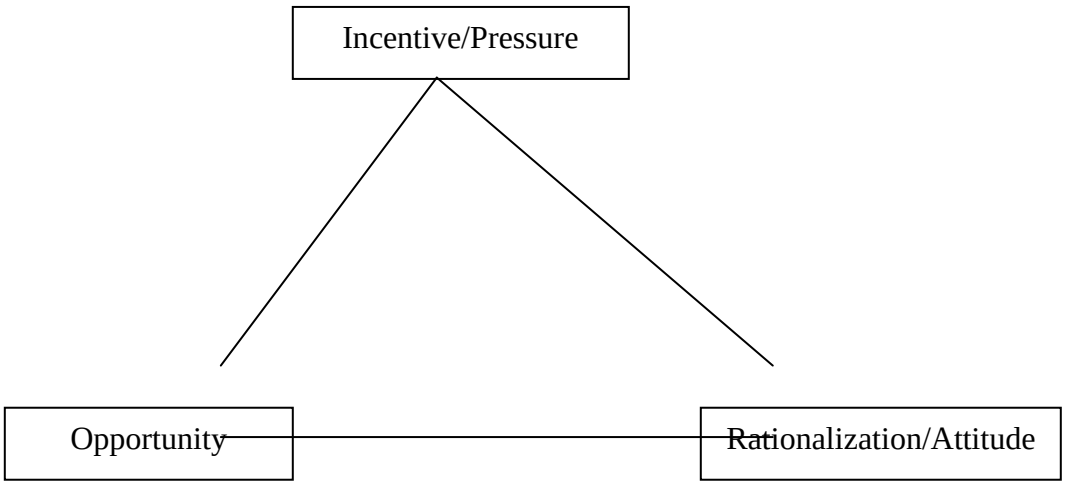
- False representation of a material fact; and
- Representation made with knowledge of its falsity.

According to an editorial of Fortune (1978) reported that increased time pressure has led independent auditors to do shoppy job in their audits. Out of 1,100 practitioners, 58 percent had indicated that they had signed off on a required audit step without completing the work or noting the omission. However, the absence of controls neither constitutes a material weakness in the accounting system, nor in auditing practice great frauds. In such cases may occur management fraud that is damaged company's financial management as well as audit practice. According to Kapnick (1980), management fraud stems from improper actions of management normally accompanied by false documentation of transactions or with holding of relevant information, resulting in a material impact on the financial statements and in financial detriment to shareholders a person acts in the representation; and the person acting is damaged by his, her reliance. According the Elliot and Willingham (1980), financial fraud is the deliberate fraud, committed by management that injures investors and creditors through materiality misleading financial statements. According to Flesher (1996), fraud means dishonesty in the form of intentional deceptions or a willful misrepresentation of fact.

Albrecht (1996) states every fraud consists of three elements:

1. Theft act, which involves taking cash, inventory, information, or other assets manually, by computer, or by telephone.
2. Concealment which involves the steps taken by the perpetrators the hide the fraud from others; and
3. Conversion, which involves selling or converting stolen assets into cash and then spending the cash.

According to Ramos (2003), fraud may occur because of three main resources namely: incentive, opportunity and, rationalization.



Source Ramos (2003)

(I) Incentive/pressure: in this position management or other employees may have an incentive or be under pressure, which provides a motivation to commit fraud as follows:

1- Business pressures:
   - To reach budgets, meet targets;
   - Maintain status as high flier in organization;
   - To prop up failing ventures or weak contracts; and
   - To get new funding.

2-Personal pressures:
   - Financial problems or extravagant life style; and
   - Drug or gambling habits-greed-not wanting to admit to problems.

(II) Opportunity: circumstances exist, for example, the absence of controls, ineffective controls, or the ability of management to override controls that provide an opportunity for fraud to be perpetrated and some other position listed below:

- Decentralization or reorganization of companies;
- High volume of major transactions;
- New and complex productions;
- Access to credit;
- No real deterrent;
- Little chance of discovery; and
- Grey areas in the rules.

(III) Rational/Attitude: those involved in a fraud are able to rationalize a fraudulent act as being consistent with their personal code of ethics. Some individuals possess as attitude, character or set of ethical values that allows them to knowingly and intentionally commit a dishonest act such as:

- Management don’t care;
- Everyone else doing it;

- No-one gets hurt;
- I am only taking what is due to me;
- Insurance will pay; and
- Only borrowing.

Ramos (2003) listed the following examples of management fraud and their underlying reasons:

- Misappropriation of assets;
- Reporting inflated assets values on operating results so that those perpetrating the fraud can retain their positions;
- Increasing their remuneration;
- Improper use of assets to the benefit of management;
- Enhancing the holding of company stock;
- Over statement of assets or under statement of liabilities to present a favorable financial position or results of operations;
- The siphoning off the assets through transactions with affiliated entities;
- Kickbacks and other irregular transactions between officers and outside parties; and
- Lack of disclosure of significant information

Sawyer (1988) believes that three conditions under which fraud exists are attributed to the environment set by management.

1. Situational pressures experienced by employees of enterprise;
2. Uncontrolled access to assets, coupled with managements indifference; and
3. Personal trait undermining personal integrity.

He lists eight reasons behind management fraud:

1. Executives sometimes take rash stops from which they cannot retreat.
2. Profit centers may distort facts he held off divestment.
3. Incompetent managers may deceive in order to survive.
4. Performance may be distorted to warrant large bonuses.
5. The need to succeed can turn manager to deception.
6. Unscrupulous managers serve interests which conflict.
7. Profits may be inflated to obtain advantages in the market place.
8. The one who controls both the assets and their records in a perfect position to falsify the records.

Fraud and audit expectation gap

A critical issue relating to auditor responsibility lies in defining as auditor's obligation to detect and report frauds or irregularities committed by clients' employees or management (Lys and Watts, 1994).

In general, the purpose of the audit practice is the enable them express an opinion as the whether the accounts presented, show a true and fair view. Therefore, the object of an audit is to ensure that the accounts on which the auditor is reporting show a true and fair view and are not misleading. The general public appears to have a high expectation that auditors will detect or prevent all fraud, in other words, third parties believed that auditors must assume a

responsibility beyond examining and attesting the fairness of financial statements and shoulder a direct obligation to protect the interest of the audit beneficiary through detecting and reporting frauds as irregularities (Sikka et al, 1992).

In the view of the fact, third parties desire external auditor who to able to certify as to the accuracy of the accounts presented, so in this condition they want that the object of an audit may be said as follows:

1. The detection of fraud.
2. The detection of technical errors.
3. The detection of errors of principle.

In short, third parties are thinking without fraud detection there is no use in audit practice whereas; the auditing profession believes its responsibilities are limited to planning the audit so that there is a reasonable expectation of detecting material fraud. However, the auditors litigating that the, detect of fraud is nor economical neither duty of auditors whereas, the other party looking for absolute assurance in audit practice.

Therefore there is gap so-called expectation gap. The expectation gap is the different between what users of financial statements, the general public perceives an audit to be and what the audit profession claim is expected of them in conducting an audit (Ojo, 2006).

The general public appears to have a high expectation that auditors will detect or prevent all fraud, whereas the auditing profession does not regard to fraud detection as primary audit objective. Thus there is an expectation gap whereby the general public believes that the auditor should be responsible for attempting to detect all fraud, in view of the fact, the frequent scandals were made to the biggest component of the audit expectation gap being auditors' perceived incapacity to detect fraud and warn of impending corporate collapses. The fraud expectation gap refers to the publics' expectation that auditors will detect fraud, and report on if it exists, whereas auditors do not accept that they have a primary responsibility to detect fraud. So far, several studies became to conclusions that auditors should also be blamed for not meeting users' expectations. Although the auditors had long been asked to detect errors or frauds (Brief, 1975), the profession's refusal of performing the fraud detection duties had fueled the expectation gap (Hooks, 1992). The professions still coming attempts to avoid fraud detection responsibility were motivated to protect its self-interest.

Fraud and audit expectation gap: some empirical evidences

In recent years academics and professionals focused on expectation gap especially regarding the effect of fraud on expectation gap. The main function of audit expectation gap is to detect fraud (Salehi and Nanjegowda, 2006) According to Baron et al (1977) conducted a questionnaire survey in the US to elicit views within the financial community on two major issues;

1. The auditor's responsibilities for detecting corporate irregularities and illegal acts; and
2. The auditor's responsibility for disclosing irregularities and illegal acts. The results revealed that auditors and other parties (financial analysts, bankers, and managers) have significantly different believes and preference on the extent of auditors' responsibilities for detecting and disclosing irregularities and illegal acts. In particular, users held auditors to be more responsible for detecting and disclosing irregularities and illegal acts than the auditors believed themselves to be. Lowe and Pany (1993) surveyed 141 members of a municipal

court juror's pool and 78 auditors from a large international accounting firm to assess their attitude toward the auditing profession. The result of the study reveals an expectation gap. The jurors view the auditors' role as that of a public watchdog or guardian to the extent of expecting the auditor to actively research out the smallest fraud. Auditors disagree with this characterization of their task.

Epstein and Geiger (1994) conducted a survey of stock investors that revealed a startling evidence of the expectation gap between the assurances auditors provided the financial statements compiled by management and the expectation of investors and other users of financial statements. Over 70 per cent of the 246 investors surveyed believe that auditors should be held responsible for detecting material misstatements due to fraud, and some 47 percent expect auditors to provide absolute assurance the financial statements contain no material misstatement due to errors. In the UK, Humphrey et al (1993) examined the expectation gap by ascertaining the perception of individuals of audit expectations issues through the use of a questionnaire. The issues investigated including the following questions. What is and should be the role of the auditor? What should be the prohibitions and regulations placed an audit firms? And what decisions could auditors be expected to make? The respondents included chartered accountants, corporate finance directors, investment analysts, bank lending officers, and financial journalists. The survey revealed significant difference between auditors and the respondents in their views on the nature of auditing. The results confirmed that an audit expectation gap exists, specifically in areas such as the nature of the audit action and the perceived performance of auditors. The critical components of the expectation gap were found to include auditors' fraud detection role and the extent of auditors' responsibilities to third parties.

McInnes (1994) reviewed Gloeck and Jayer's (1993) study on the audit expectation gap in the Republic of South Africa and found three areas namely, independence of auditors, role of auditors relating to fraud and going concern issues in which an expectation gap exists between auditors and non-auditors.

Low (1984) conducted a survey amongst auditors and analysts in Singapore and Australia results revealed that in both countries, significant differences in perceptions were found in areas pertaining the extent of assurance over fraud detection and the reliability of information presented in audited financial statements. Another survey conducted by Low et al (1988), who surveyed a sample of auditors and financial analysts in Singapore regarding their perception of objectives of company audits. Participants were provided with a list of 13 potential objectives. Significant differences and expectation gaps were found in the areas of fraud prevention, guaranteeing the accuracy of financial information, effective utilization by the company of government grants, levies and subsidies, and management. A study by Best et al (2001) sought to determine the level and nature of the expectation gap for various areas of auditor responsibility. They gather information through the questionnaire and participants were auditors, bankers, and investors. Their results indicated a wider expectation gap in the areas of the auditor's responsibility for preventing and detecting fraud, maintenance of accounting records, and selection of appropriate auditing procedures. MC Enroe and Martens (2001) surveyed public accountants and individual investors to determine the extent to which the

expectation gap exists for various facets of the attest function an found investors have higher expectations than auditors in the areas of disclosure, internal control, fraud and illegal operations. Another survey carried out by MC Enroe and Martens (2002) by comparing audit partners' and investors' perceptions of auditors' responsibilities involving various dimensions of the attest function. The results revealed that an expectation gap currently exists: investors have higher expectations for various facts and assurances of the audit than do auditors in the following areas: disclosure, internal control, fraud, and illegal acts. It was also found that investor expect auditors to act as public watchdog. Koh and Woo (2001) investigated the audit expectation gap between auditors and management and found a significant gap, which management expecting more that auditors in the areas of preventing and detecting fraud, illegal acts, errors, and in guaranteeing the accuracy of financial reports. Study conducted by Fadzly and Ahmad (2004) regarding several dimensions of expectation gap in Malaysia. Questionare instrument were used for information collecting and participants were auditors, bankers, brokers, investors, and experimental. The results revealed evidence of expectation gap in Malaysia from the viewpoint of auditors and other participants, particularly on issues of concerning auditor's responsibilities. A wide gap was found regarding auditor's responsibilities in fraud detection and prevention, preparation of financial statements and accounting records. The gap was also found regard to auditor's scope of legal responsibility in a fraud related business failure. More recent survey conducted by Alleyne and Howard (2005), between auditor and users around the responsibility of auditor for fraud detection through interview in Barbados. The results revealed that there is wide expectation gap between auditors and users for fraud detection. The auditors strongly disagreed that they were responsible for uncovering fraud compared to the users' strongly view that they should be responsible.

On another fashion, a survey conducted by Beelde et al (2005) relating to audit expectation gap in Belgium. Participants were auditors, bankers, and managers. The results revealed that there are significant differences between auditors and other parties in several fields such as going concern, auditor role, auditing process, liability of auditors to third parties, and fraud and illegal prevention. In addition results revealed that there is an expectation gap with regard to the attributes detecting and preventing errors'. 89% of the auditors were convinced that they are good at detecting errors, but only 78% of the managers and 62% of the bankers agree with this. 63% of the auditors were of the auditor is of the opinion that they are good at preventing errors, but it must be emphasized that some 5% of the auditors are of the opinion that this is not revealed. 44% of the managers believed that auditors were good at this, 26% believed that they achieved an average result and 29% was of the opinion that they were bad at it. Only 1% was of the opinion that this is not part of the job responsibilities of an auditor. The results for the bankers are as follows: 29% good, 22 % average, 42% bad, and 7% not relevant.

Conclusion

As mentioned before the publics' perception of auditor responsibility differs from that of the profession regarding fraud detection. The auditor believes the auditors have the task of providing assurance that financial statements are not materially misleading. Thus, making them

reliable for decision-making. However, when the auditors' lazy about fraud, the usefulness of the audit is damaged as investors make decisions using unreliable information.

The outcome of such conditions is an inefficient allocation of capital, which may ultimately slow economic growth; furthermore it create fraud expectation gap. Auditors have the task of providing assurance that financial statements are not materiality misleading, thus making them reliable for decision-making. When auditor's fail in their assessment of fraud, the usefulness of the audit is damaged the potential result is an inefficient allocation of capital, which may ultimately slow economic growth (Ellitto and Willingham, 1980).

A Chinese philosopher once said "a journey of a thousand miles begins with a single step, in this situation both auditors and legislators should be taken actions. The legislators can enact more regulation for detecting fraud and illegal acts as well as renew old regulations. Auditors should be have more interest in improving fraud detection because of the deleterious effect fraud has on credibility as professionals, otherwise the same old story in the same old day will be repeated.

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